DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 07-0203
Sales and Use Tax
For the Years 2002, 2003, and 2004

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ISSUES

I. **Tax Administration –** Interest on Claim for Refund.

Authority: IC § 6-8.1-9-1; IC § 6-8.1-9-2; 45 IAC 15-9-2.

Taxpayer protests that audit-generated refunds it received were erroneous because they did not include interest.

II. **Use Tax –** Manufacturing Exemption – Labeling Equipment.

Authority: IC § 6-8.1-5-1; IC § 6-2.5-3-2; IC § 6-2.5-5-6; 45 IAC 2.2-5-8; 45 IAC 2.2-5-14; *Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue*, 867 N.E. 2d 289 (Ind. Tax Ct. 2007); *Indiana Dep't of State Revenue v. Kimball Int'l, Inc.*, 520 N.E.2d 454 (Ind. Ct. App. 1988).

Taxpayer protests the assessment of use tax on labels it argues it uses in its manufacturing process.

STATEMENT OF FACTS

Taxpayer is a Delaware corporation domiciled in Arkansas at the corporate headquarters of its parent. Taxpayer has a manufacturing plant in Indiana. Taxpayer is engaged in the processing of food products that it sells to a major chain and grocery deli operations. The food is frozen prior to shipment to stores. Technically, all of Taxpayer's sales are to a sales and distribution sister company. Indiana Department of State Revenue (Department) conducted a sales and use tax audit of Taxpayer for tax years 2002, 2003, and 2004. The audit commenced in July 2005 and was completed on January 9, 2007.

According to the Department's audit report, during the audit period Taxpayer accrued and remitted a considerable amount of use tax. Also during this time period Taxpayer changed accounting systems. As a result of this change use tax was inadvertently

remitted on items that were non-taxable items such as labor, seminars (with no materials provided), conferences, classified ads, certification fees, surveys, testing, lump sum contracts for improvements to realty, wrecker services, maintenance inspections, production utilities, and others areas. The Department allowed for both sales taxes paid and use tax accrued in cases where the items were exempt.

The audit resulted in overpayment determinations for each of the tax years. The Department applied the overpayments against taxes due in each of those years, then issued a refund check for the remainder overpayments on March 1, 2007. The refund checks did not include any interest on the refunded amount.

P.L. 111-2006, Sec. 10, effective January 1, 2007, amended IC § 6-8.1-9-2(c) to accrue interest on a refund after 90 days from the date a refund claim is filed rather than after 90 days from " the date the tax payment was due or the date the tax was paid, whichever is later[…]." This legislation was signed into law on March 20, 2006.

Taxpayer protests that the Department did not pay interest on refunds that resulted from audit-generated overpayments due to an undue audit delay that coincided with an amendment to IC § 6-8.1-9-2(c) which, Taxpayer contends, changed the Department's obligation to pay interest. A hearing was held on Taxpayer's protest. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. **Tax Administration –** Interest on Claim for Refund.

DISCUSSION

Taxpayer protests that the Department did not pay interest on audit-generated refunds.

Taxpayer states its protest as follows:

> [Taxpayer]'s objection to the lack of interest is that the auditor had more than enough time to complete the audit prior to the end of 2006 due to some "health issues" he had encountered. We ask that the State take this fact into consideration and award [Taxpayer] the interest on this refund audit that is justly due them.

At the hearing, Taxpayer argued that it should receive interest on its refund calculated from the date the taxes were paid.

Taxpayer argues two main issues: (1) that it made a claim for refund during the audit, and (2) had the audit been completed in 2006, Taxpayer would have had a right to interest on the audit-generated refunds, and that the auditor's illness had contributed to this delay.

The statutes that deal with tax overpayments and claims for refund are IC § 6-8.1-9-1 and IC § 6-8.1-9-2.

IC § 6-8.1-9-1 states:

> (a) If a person has paid more tax than the person determines is legally due for a particular taxable period, *the person may file a claim for a refund with the department*. Except as provided in subsections (f) and (g), in order to obtain the refund, the person must file the claim with the department within three (3) years after the latter of the following:
>
> (1) The due date of the return.
>
> (2) The date of payment.
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> For purposes of this section, the due date for a return filed for the state gross retail or use tax, the gasoline tax, the special fuel tax, the motor carrier fuel tax, the oil inspection fee, or the petroleum severance tax is the end of the calendar year which contains the taxable period for which the return is filed. The claim must set forth the amount of the refund to which the person is entitled and the reasons that the person is entitled to the refund.
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> (b) When the department receives a claim for refund, the department shall consider the claim for refund and shall, if the taxpayer requests, hold a hearing on the claim for refund to obtain and consider additional evidence. After considering the claim and all evidence relevant to the claim, the department shall issue a decision on the claim, stating the part, if any, of the refund allowed and containing a statement of the reasons for any part of the refund that is denied. The department shall mail a copy of the decision to the person who filed the claim. If the department allows the full amount of the refund claim, a warrant for the payment of the claim is sufficient notice of the decision.
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> (c) If the person disagrees with any part of the department's decision, the person may appeal the decision, regardless of whether or not the person protested the tax payment or whether or not the person has accepted a refund. The person must file the appeal with the tax court. The tax court does not have jurisdiction to hear a refund appeal suit, if:
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> (1) the appeal is filed more than three (3) years after the date the claim for refund was filed with the department;
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> (2) the appeal is filed more than ninety (90) days after the date the department mails the decision of denial to the person; or
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> (3) the appeal is filed both before the decision is issued and before the one hundred eighty-first day after the date the person files the claim for refund with the department.
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> (d) The tax court shall hear the appeal de novo and without a jury, and after the hearing may order or deny any part of the appealed refund. The court may assess the court costs in any manner that it feels is equitable. The court may enjoin the collection of any of the listed taxes under IC 33-26-6-2. The court may also allow a refund of taxes, interest, and penalties that have been paid to and collected by the department.
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> (e) With respect to the motor vehicle excise tax, this section applies only to penalties and interest paid on assessments of the motor vehicle

> excise tax. Any other overpayment of the motor vehicle excise tax is subject to IC 6-6-5.
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> (f) If a taxpayer's federal income tax liability for a taxable year is modified by the Internal Revenue Service, and the modification would result in a reduction of the tax legally due, the due date by which the taxpayer must file a claim for refund with the department is the later of:
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> (1) the date determined under subsection (a); or
>
> (2) the date that is six (6) months after the date on which the taxpayer is notified of the modification by the Internal Revenue Service.
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> (g) If an agreement to extend the assessment time period is entered into under IC 6-8.1-5-2(f), the period during which a person may file a claim for a refund under subsection (a) is extended to the same date to which the assessment time period is extended.

IC § 6-8.1-9-2 states:

> (a) If the department finds that a person has paid more tax for a taxable year than is legally due, the department shall apply the amount of the excess against any amount of that same tax that is assessed and is currently due. The department may then apply any remaining excess against any of the listed taxes that have been assessed against the person and that are currently due. If any excess remains after the department has applied the overpayment against the person's tax liabilities, the department shall either refund the amount to the person or, at the person's request, credit the amount to the person's future tax liabilities.
>
> (b) If a court determines that a person has paid more tax for a taxable year than is legally due, the department shall refund the excess amount to the person.
>
> (c) An excess tax payment that is not refunded or credited against a current or future tax liability within ninety (90) days after the date the refund claim is filed, the date the tax payment was due, or the date the tax was paid, whichever is latest, accrues interest from the date the refund claim is filed at the rate established under IC 6-8.1-10-1 until a date, determined by the department, that does not precede by more than thirty (30) days, the date on which the refund or credit is made.
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> (d) As used in subsection (c), "refund claim" includes an amended return that indicates an overpayment of tax.

Prior to January 1, 2007, IC § 6-8.1-9-2(c) accrued interest on a refund after 90 days from “the date the tax payment was due or the date the tax was paid, whichever is later[…]” rather than from “the date the refund claim is filed.” IC § 6-8.1-9-2(c) (as amended by P.L. 111-2006, Sec. 10, effective January 1, 2007). This legislation was signed into law on March 20, 2006, prior to Taxpayer’s statement of overpayments to the auditor in the instant case.

45 IAC 15-9-2(b) states:

> The department has no legal method of generating a claim for refund. A claim for refund can only be initiated pursuant to IC 6-8.1-9-1.
>
> EXAMPLE
> A taxpayer is audited by the department for the tax period 19X3. This audit results in an overpayment of tax. The department has no legal authority to automaticaly [sic.] refund or credit this overpayment to the taxpayer. Instead, the taxpayer must file a claim for refund as prescribed in IC 6-8.1-9-1 and 45 IAC 15-9-1.

During the course of the audit, the auditor received a spreadsheet from Taxpayer stating what Taxpayer determined were overpayments of tax. The spreadsheet included over 30,000 line items. These were reviewed as part of the ongoing exchange between the auditor and the Taxpayer within the global scope of the audit. The Taxpayer's statement of overpayments was not a separate claim for refund outside the scope of the ongoing audit. These line items were under continuous review, including through regular communication with Taxpayer, throughout the remaining duration of the audit.

The result of the completed audit was that Taxpayer had made overpayments. The Department, therefore, *found* that there were *overpayments at the conclusion of the audit* on January 9, 2007.

Taxpayer *did not file a claim for refund* per IC § 6-8.1-9-1(a). Taxpayer acknowledged as much at the hearing. Furthermore, per 45 IAC 15-9-2(b), the Department had no legal method for generating a claim for refund. Also, IC § 6-8.1-9-1 and IC § 6-8.1-9-2 are silent on audit-generated refunds. Per the guidance set out in the example in 45 IAC 15-9-2(b), Taxpayer could have filed a claim for refund on the audit-generated overpayments.

In this instance, the Department nonetheless did, on its own initiative, refund Taxpayer following the procedure set out in IC § 6-8.1-9-2(a). The Department applied the overpayments in each of the years at issue against the amounts of those same taxes that were assessed and currently due. Per IC § 6-8.1-9-2(a), the Department could also then have applied any remaining excess against any other listed taxes currently due, but it did not do so, nor was the Department required to. Per IC § 6-8.1-9-2(a), the Department then refunded Taxpayer the remainder of the overpayments.

IC § 6-8.1-9-2(c) deals with when the interest calculation is triggered on a refund. It first sets out a 90-day deadline from when the claim for refund is filed, the date the tax payment was due, or the date the tax was paid, whichever is latest. If the Department refunds the taxpayer the overpayment before this deadline, the Department does not owe the taxpayer any interest on the refund. However, IC § 6-8.1-9-2(c) then states that if the Department misses this deadline, then the Department owes the taxpayer interest on the refund, and this interest is calculated from when the claim for refund was filed.

The claim for refund, according to IC § 6-8.1-9-1(a) and 45 IAC 15-9-2, can only be made by Taxpayer. Therefore, by implication, this means that a claim for refund must be filed for interest to be calculated on a refund, irrespective of which date triggered the 90-day countdown. In other words, the filing of a claim for refund, is the condition precedent for the Department owing any interest on a refund. Interest is owed only when a refund is issued pursuant to a claim for refund, which, by definition, can only be initiated by a taxpayer, and then only if the Department does not refund the overpayment within the stated deadline.

Per IC § 6-8.1-9-2(a), when the Department finds an overpayment, the Department is required to apply that overpayment against any amount of that same tax that is assessed and is currently due. Also per IC § 6-8.1-9-2(a), the Department could also then apply any remaining excess against any other listed taxes currently due but is not required to do so. Per IC § 6-8.1-9-2(a), if any excess remains after the Department has applied the overpayment against Taxpayer's tax liabilities, the Department is required to refund the amount to Taxpayer, or, at Taxpayer's request, credit the amount to the person's future tax liabilities.

In the case where the Department finds an overpayment as a result of its investigation of a claim for refund, IC § 6-8.1-9-2(c) requires the Department to refund the overpayment to the taxpayer within 90 days of the latest of the triggering dates referenced in IC § 6-8.1-9-2(c) to avoid paying interest on the refund. If the Department misses the 90-day deadline, then the Department would owe the taxpayer interest on the amount refunded as of the date the claim for refund was filed (per amended (c) effective Jan. 1, 2007).

In the case where the Department finds an overpayment of tax outside the context of an investigation of a, by definition taxpayer-initiated, claim for refund, the Department is still obligated to follow the refund procedure set out in IC § 6-8.1-9-2(a) for the overpayment. However, since there is no taxpayer-initiated claim for refund the obligation to pay interest under IC § 6-8.1-9-2(c) is absent.

Lastly, Taxpayer points to delay due to auditor health issues. This consideration is not a legal factor. However, it should be noted that the auditor's absence as a result of surgery lasted for three days during the Thanksgiving week in 2006. This "delay" was minor and did not affect the ultimate timing of the audit conclusion. Moreover, the argument could be made that the difficult formatting in which Taxpayer presented its information to the Department during the audit consumed as much, if not more, time as the auditor's brief absence did. It stands to reason that whatever "delays" may have occurred were a reasonable part of an audit process. The audit was exhaustive and took a considerable amount of time with much back and forth between Taxpayer and auditor. The audit itself is well documented and its completion date is not a legal issue.

Even if the Department had, for the sake of argument, the authority to claim a refund on behalf of Taxpayer upon completion of the audit, interest would not have been due to Taxpayer on the refund because the Department issued the refund on March 1, 2007, well within 90 days of the completion of the audit on January 9, 2007.

FINDING

Taxpayer's protest is respectfully denied.

II. **Use Tax –** Manufacturing Exemption – Labeling Equipment.

DISCUSSION

The Department's audit denied Taxpayer the manufacturing exemption on labeling equipment (Slapp Project) that Taxpayer argues is basically the same equipment that was exempted in a prior supplemental Letter of Finding (98-0558) for a related entity. Taxpayer argues in its letter of protest, dated April 10, 2007, that "[a]lthough the legal entity and products are different, the same principle and equipment is involved in both cases."

In a further pre-hearing letter dated September 20, 2007, Taxpayer explains its protest:

> The laser printer from the previously mentioned Letter of Findings was physically connected to a control panel/input computer. With the advances in technologies, the printers listed in the Slapp project receive their information wirelessly from the control box, input computer, and weigh scales further up the production process. Hence, the need for a wireless Ethernet card, wireless work group bridge, printer server, and industrial computer. These items replace the need for physically attaching controlling/input mechanisms to the printer itself. The printer in the Slapp project is different in nature to the laser printer referenced above in that the laser printer physically prints to the container, where the new Slapp printers produce a physical label, which is then applied to the container through an automated process. The new Slapp project labels contain more information than the laser printer provided previously. The new Slapp labels include ingredients, cooking instructions, along with the same information that the laser printer provided. Therefore, it is simply an upgrade to the labeling system over the previously listed laser printer.

The Department's audit report describes the Slapp equipment as "labeling equipment used for the purpose of applying labels to the final packaging." Taxpayer contends the labeling equipment in question applies labels that identify the Taxpayer, the product, lot numbers, packaging dates, etc. Taxpayer affixes these labels to the non-returnable boxes containing various counts of Taxpayer's finished product, as individually packaged product to be purchased by its customers. The Department's audit report cites 45 IAC 2.2-5-14, which delineates three tests which items must meet to qualify for the incorporation exemption. The first test requires "that the material must be physically incorporated into and become a component of the finished product." The report continues:

> In this case, the final product is the item such as the packaged product parts that the store buys. Taxpayer does not attach the labels directly to or physically incorporate them into the finished product, which is the individual package of product to be sold to the ultimate customer in the grocery store. Rather, the taxpayer attaches the labels directly to and physically incorporates them into the box containing several of the finished products.

All tax assessments are presumed to be accurate and the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(b), (c); *Lafayette Square Amoco, Inc. v. Indiana Dep't of Revenue*, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Indiana imposes "an excise tax, known as the use tax," on tangible personal property that is acquired in retail transactions and is stored, used, or consumed in Indiana. IC § 6-2.5-3-2(a).

In general, all purchases of tangible personal property by persons engaged in the direct production, manufacture, fabrication, assembly or finishing of tangible personal property are taxable. 45 IAC 2.2-5-8(a).

IC § 6-2.5-5 states some exemptions from the assessment of sales and use tax. IC § 6-2.5-5-6 states:

> Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufactures, assembles, refines, or processes for sale in his business…

More specifically, 45 IAC 2.2-5-14 states in relevant part:

> (d) The purchase of tangible personal property which is to be incorporated by the purchaser as a material or an integral part is exempt from tax. Incorporated as a material or an integral part into tangible personal property for sale by such purchaser" means:
> (1) That the material must be physically incorporated into and become a component of the finished product;
> (2) The material must constitute a material or an integral part of the finished product; and
> (3) The tangible personal property must be produced for sale by the purchaser.
>
> (e) Application of the general rule.
> (1) Incorporation into the finished product. The material must be physically incorporated into and become a component part of the finished product.

(2) Integral or material part. The material must constitute a material or integral part of the finished product.
(3) The finished product must be produced for sale by the purchaser.

In applying any tax exemption the general rule is that "tax exemptions are strictly construed in favor of taxation and against the exemption." *Indiana Dep't of Revenue v. Kimball Int'l Inc.*, 520 N.E.2d 454, 456 (Ind. Ct. App. 1988).

The audit determined that the labels were subject to sales tax because the labels were not "incorporated" into the taxpayer's manufactured products. Taxpayer argues that IC 6-2.5-5-6 provides that statutory authority for its assertion that the labels are exempt from sales tax. The statute states in relevant part that, "Transactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for incorporation as a material part of other tangible personal property which the purchaser manufacturers, assembles, refines, or processes for sale in his business." In effect, taxpayer argues that the labels are "incorporat[ed] as a material part" of its products. Departmental regulation 45 IAC 2.2-5-14 provides specific guidance in applying the general statutory rule. The regulation states that in order to find that material is incorporated into the property produced for resale, "[t]he material must be physically incorporated into and become a component of the finished product . . . . [t]he material must constitute a material or integral part of the finished product . . . . [t]he finished tangible personal property must be produced for sale by the purchaser." 45 IAC 2.2-5-14(d).

There can be little dispute that taxpayer's labels are an essential component within taxpayer's marketing and distribution process. Notwithstanding, the purchase of taxpayer's labels is not entitled to the manufacturing exemption afforded under IC 6-2.5-5-6 because the labels do not become a "material part" of the taxpayer's products. The labels do not "constitute a material or integral part of the finished product," (45 IAC 2.2-5-14(d)(2)) because the labels are not essential to the taxpayer's finished product and because the labels do not affect the utility of that finished product. The labels are merely the ancillary means by which taxpayer's finished product finds its way to the ultimate consumer.

Taxpayer has not shown that the labels it uses qualify for the incorporation exemption set out in IC § 6-2.5-5-6 and 45 IAC 2.2-5-14(d)(2).

FINDING

Taxpayer's protest is respectfully denied.